Audit fees and audit adjustments: evidence from Welsh local authorities

Richard M. Baylis and Margaret J. Greenwood

This paper exploits the availability of pre-audit financial statements to investigate the scale and incidence of audit adjustments and their impact on audit fees in Welsh local authorities. Adjustments to the politically-sensitive general fund, which represent a significant proportion of all adjustments, are associated with increased audit fees. The authors also found that audit adjustments on average result in more conservative reporting of the surplus/deficit and the balance on the general fund, with the number and value of downward adjustments exceeding those of upward movements.

Keywords: Audit adjustments; audit fees; financial reporting; local government; Wales.

The UK's general election in May 2015 refocused public and political attention on the national budget deficit and has reinvigorated the public debate about the need for reductions in public spending. The Welsh Government has, until recently, protected its local authorities from the deep spending cuts imposed in England as a consequence of the programme of 'austerity', which has been in place in the UK since 2010. However, continuing pressure on the overall funds devolved to the Welsh Government has led to cuts at the local level (3.5% in 2013–14 and 4.5% in 2014–15) and has prompted a debate about the potential impact on local authority services. The Welsh Government has thus urged local authorities to plan reductions in a way which limits the impact on those who depend most on their services (*BBC News*, 2014).

The pressing need for councils to review costs at every level was highlighted in 2013 by the Welsh local government shadow minister, who was reported as saying: 'Welsh councils need to go through their budgets line by line and eliminate wasteful spending, improve their tax collection rates and deliver services in more imaginative ways' (*BBC News*, 2013).

Welsh public spending amounts to approximately £30 billion a year (HM Treasury, 2013, p. 114), of which approximately £8 billion is spent by local authorities. At times of financial pressure, when managers may face particularly acute incentives to manage their reported financial performance in order to access higher levels of funding or to avoid political costs and regulatory intervention, the role of audit as an assurance mechanism for the integrity of the financial statements is particularly important for stakeholders. However, expenditure on audit services is far from immune from pressures for reductions in spending.

Audit fees for Welsh local authorities are determined by the Wales Audit Office (WAO), the regulator of local audits in Wales, mainly with reference to the size of the local authority. Since 2010, in response to austerity pressures, these fees have been reduced by 21.6% in real terms (WAO, 2014, p. 6). This is, however, much less than the nominal fee reductions of 40% which have been experienced as a consequence of the radical and controversial reform of public audit in England (Local Audit and Accountability Act 2014), which has involved the abolition of the Audit Commission (the English equivalent of the WAO) and the transfer of audit performance to private sector audit firms. Such a policy has not as yet been embraced by the Welsh Government, and the Auditor General for Wales continues, at least for the time being, to retain considerable control over the pricing, quality and execution of local audit.

Audit fees are, however, not only a function of audit efficiency and effectiveness, but also of the quality of the financial statements presented for audit. Audit adjustments as a consequence of poor pre-audit financial reporting quality are costly both in terms of additional auditor effort, which is likely to impact fees, and in terms of auditee effort, in negotiating the extent of adjustments. Improved pre-audit financial reporting quality thus has the potential to reduce fees and deliver internal cost savings. Further, in the distinctive setting of UK local authorities, which are required to publish pre-audit financial statements for public scrutiny, increased pre-audit financial reporting quality may also deliver other benefits such as an enhanced reputation

Richard Baylis is a lecturer in accounting at Cardiff Business School, UK.

Margaret Greenwood is a lecturer in accounting at the University of Bath School of Management, UK.

for financial governance and stakeholder accountability. In this paper we exploit the public availability of these pre-audit financial statements to investigate the incidence and scale of audit adjustments and their association with audit fees for Welsh local authorities in the period 2005–06 to 2009–10.

Prior research

Research into audit adjustments is limited and has historically been constrained by data access issues. Such research requires access either to the pre-audit financial statements, which are not normally published, or access to auditor working papers which are subject to commercial and client confidentiality. The majority of studies have therefore exploited special access to the working papers of one or more audit firms (Hylas and Ashton, 1982; Kinney and McDaniel, 1989) or have adopted a survey based research instrument (Kreutzfeldt and Wallace, 1986; Johnson, 1987; Houghton and Fogarty, 1991; Bell and Knechel 1994; Wright and Wright, 1997).* Further, these studies have focused almost exclusively on the private sector in a US setting. More recently, studies have been extended to alternative settings, such as Germany (Ruhnke and Schmidt, 2014), China (Chan *et al*., 2003), South Africa (Houghton and Fogarty, 1991) and Norway (Eilifsen and Messier, 2000). A general finding of these studies is that audit adjustments serve to reduce reported income (Kinney and Martin, 1994).

An interesting feature of the not-for-profit and public sectors is that it is sometimes possible to access pre-audit financial statements. Grein and Tate (2011), for example, exploit the availability of such statements to investigate the scale and incidence of audit adjustments in US public housing associations and their impact on financial reporting quality. Consistent with prior studies, they find that audit adjustments are economically significant and that they have an asymmetry which suggests greater concern with potential overstatement of performance than understatement.

Prior UK audit studies in the not-for-profit and public sectors have so far considered the determinants of both audit quality (Ballantine *et al*., 2008) and audit fees. These latter studies have been performed in the National Health Service (Clatworthy *et al*., 2002, 2008; Basioudis and Ellwood, 2005a; Ellwood and Garcia-Lacalle, 2012, 2015), in universities (Mellet *et al*., 2007), in charities (Beattie *et al*., 2001) and in local authorities (Giroux and Jones, 2007). To date however there have been no studies on audit adjustments in these settings.

We extend this limited literature to consider the scale and impact of audit adjustments in the setting of Welsh local authorities where pre-audit financial statements are publicly available.

The institutional, legal and regulatory setting

The UK local authority setting is characterized by a number of distinctive features relating to financial accountability, accounting, and audit.

Local authority financial accountability

UK local authorities are elected bodies with responsibility for delivering local public services such as education, transport, cultural and leisure services and refuse collection. Their main constraint is the requirement to produce a balanced budget, in which the current year expenditure does not exceed revenue from government and local taxes, plus the balance on the authority's general fund (the equivalent of retained earnings).

The balance on the general fund is characterized by considerable political and legal sensitivity. Politically, the general fund represents a start point for determining how much a local authority needs to raise in terms of local taxes in order to support its services. Too low a balance can point to the need to raise more revenue from local residents and businesses, while too healthy a balance can lead to pressure to reduce tax rates. Further, the provisions of s. 114 of the Local Government Finance Act 1988, which essentially freeze any new council expenditure, can be triggered if the balance on the general fund falls to a level such that total available resources fall short of expenditure.

A distinctive feature of this local authority setting is the requirement to publish financial statements presented for audit (Public Audit [Wales] Act, 2004, s. 30; National Assembly for Wales, 2005) so that the public and councillors may raise any issues of concern with the auditor. This rare feature of the local authority setting permits an investigation of audit adjustments and their impact on audit fees.

Local authority financial accounting and audit

The content of Welsh local authority financial statements is set out in the Accounts and Audit (Wales) Regulations 2005 and the Code of Practice on Local Authority Accounting in the United

*Although ISA 260 requires auditors to disclose audit adjustments to those charged with governance, it was not in effect at the time of these studies. As a consequence of the publication of ISA 260, the auditor's communication to those in governance represents an additional potential source of research data but, in the case of the private sector, remains subject to commercial and client confidentiality.

Kingdom (National Assembly for Wales, 2005, para. 10). Consistent with a wider programme of public sector reform, which draws its inspiration from managerial best practice in the private sector (Hood, 1991, 1995), these financial statements have increasingly adopted private sector accounting norms with the adoption of UK Generally Accepted Accounting Practice (GAAP) and, from 2010–11, International Financial Reporting Standards (IFRS). However, the adoption of private sector accounting standards has been subject to much critical comment on the basis that such accounting practices were developed in a private sector context and do not therefore adequately reflect the distinctive institutional and regulatory features of the public sector setting where services are often in the nature of public goods and cannot easily be traded in markets (Ellwood, 2009), where capital is largely obtained from the public purse and not from private investors, and where service delivery is the primary objective rather than profit generation (Ellwood, 2003; Barton, 2004, 2005; Ellwood and Newbury, 2006). The income of local authorities, for example, is largely derived from government grant funding, some of which is earmarked for specific purposes. As a consequence, elements of the surplus/deficit are transferred, under statutory requirement, to other reserves. Examples include depreciation, impairment of fixed assets, and net gains/losses on the sale of fixed assets. The result is that the surplus/deficit recorded in the income and expenditure account, which in other settings is a primary focus for performance measurement and evaluation, is not the balance which is transferred to the general fund, the equivalent of retained earnings in the private sector. Only after these reserve transfers have been effected is the remaining surplus/deficit transferred to the general fund. An illustration is shown in figure 1: this shows how the Cardiff City Council's 2007 deficit on the income and expenditure account of -£49,382k is transformed by transfers of certain classes of income and expenditure to other reserves. The largest transfer was that of depreciation and impairment of fixed assets which totalled £67,577k. The culmination of these transfers results in a final direct transfer of only -£325k to the general fund. As a consequence, the meaning of the reported surplus is more ambiguous than in other sectors and given the sensitivity associated with the balance on the general fund we predict that audit fees will be more sensitive to adjustments to the general fund than to the reported surplus/deficit.

Since 2005, the appointment of auditors, the determination of audit fees and the monitoring of audit quality for Welsh local authorities have been regulated by the WAO. Fees are largely determined by reference to an authority's gross expenditure but some flexibility is applied in order to reflect local factors such as variations in the quality of the financial statements presented for audit (see, for example, WAO, 2007). We can therefore expect that local authorities with a higher incidence of audit adjustments will experience higher audit fees.

The Auditor General for Wales has overall responsibility for the WAO and has a duty to appoint local government external auditors and to ensure quality and standards are upheld (Public Audit [Wales] Act 2004, s. 14). For each audit there is a named engagement lead who is responsible for the performance of the audit and for making a recommendation to the appointed auditor, who is a member of the WAO, for his or her consideration and decision as to the form of audit report which should be issued. Approximately 60% of audits are performed by the staff of the WAO, with the remaining 40% being performed by approved private sector firms.

The investigation

In this study we investigated the scale and incidence of audit adjustments and their association with audit fees. Using pre- and post-audit financial statements, we measured the size of audit adjustments as being the percentage change between the pre- and post-audit financial statements on three potentially sensitive balances:

- The surplus/deficit on the income statement because this is the headline figure representing the focus for press and public comment.
- The transfer to the general fund from the income statement because this represents an indication of an increasing or decreasing risk to a rise in council tax.
- The balance on the general fund, which is an indicator of the overall health of the local authority and a measure of the risk of a rise in council tax.

These measures are summarized in figure 2. Adjustments to asset figures, although they can

Figure 1. The balance on the income and expenditure account and the transfer to the general fund.

	(£000)
Surplus/(deficit) per the income and expenditure account	(49,382)
Balances statutorily transferred to other reserves	49,057
Balance transferred to the general fund	(325)

be material, do not have the same level of political sensitivity or impact on the general fund (as discussed previously). However, our measures ~~did~~ capture the extent to which adjustments to asset values flow through to the income statement and general fund.

In the local authority setting, audit fees are determined, in the first instance, by reference to their service expenditure. A plot ~~(available from the authors)~~ confirmed the linear relationship between total service expenditure and audit fees, with the exception of two outlier observations where the audit fees were significantly above trend because of accounting anomalies and an investigation into members' expenses. We therefore adopted audit fees as a percentage of total service expenditure as our variable of interest.

Data and sample

The period of our investigation was from 2005–06 up to 2009–10, just prior to the introduction of IFRS. This period was selected to avoid potential distortions in audit fees and pre-audit financial reporting quality during the period of transition, which could arise for both the auditor and the auditee as a consequence of the need for familiarization with the new regime (De George *et al*., 2013).

There are 22 Welsh local authorities, so for our five-year study period the maximum number of observations was 110. We omitted the two outlier observations from this total. One further observation was unavailable, failing a response from the local authority, resulting in a final sample size of 107 observations.

Data on audit fees and audit adjustments were sourced manually from the post-audit and pre-audit financial statements ~~for the period 2005–06 to 2009–10. These~~ were accessed from local authority websites or by direct request.

Findings

Table 1 shows that the mean expenditure for Welsh local authorities was £379 million, with a variation ranging from a minimum of £164 million to a maximum of £1.4 billion. Audit fees represented a small percentage of this, with a mean fee of £250,000, ranging from £128,000 to £463,000. The general fund had a mean value of £8.6 million, representing 2.3% of total service expenditure which is consistent with a wish to fully utilize funds while not exposing the authority to undue risk. However, this contrasts with the mean surplus/deficit which amounted to a deficit of £38 million, representing over 10% of service expenditure. These two apparently conflicting figures can be reconciled by reference to the distinctive features of local authority financial statements and, in particular, the disconnect between the reported surplus/deficit and the amount of funds transferred to the general fund. Table 1 further shows that the mean transfer to the general fund was positive (in contrast to the headline deficit) and increased the balance on the general fund by a mean value of £220,000. The difference between the mean reported deficit of £38 million and the mean transfer to the general fund of £220,000 is indicative of the scale of the balances which are statutorily transferred to other reserves.

The incidence of audit adjustments was widespread with adjustments to the reported surplus/deficit in 92 out of 107 (86%) observations, to the transfer to the general fund in 46 (43%) instances, and to the balance on the general fund in 48 (45%) cases. The mean absolute value of these adjustments was also substantial: the mean adjustment to the general fund amounted to an absolute value of £591,000 (representing 7% of the mean balance on the general fund), and the mean adjustment to the amount transferred to the general fund was £525,000 (almost double the mean transfer value of £220,000). The scale and number of these adjustments is a reflection of the political sensitivity of the general fund and an indication of the extent of auditor scrutiny of these balances. The mean adjustment to the surplus/deficit was also substantial at £11 million, as compared with the reported mean deficit of £38 million, but this was skewed by an outlier maximum of £387 million. The median therefore probably provides a more representative figure of £2 million, representing an adjustment of just over 5%. These figures demonstrate the scale and scope of audit adjustments. Almost all of the

Figure 2. Measures of pre-audit financial reporting quality.

Measure	*Abbreviation*	*Definition*
% adjustment to the reported surplus/deficit (SD)	DSD%	Audited SD - unaudited SD x 100%/ unaudited SD
% adjustment to the transfer from the income statement to the general fund (GF)	DSGF%	Audited transfer - unaudited transfer x 100%/ unaudited transfer
% adjustment to the general fund	DGF%	Audited GF - unaudited GF x 100%/ unaudited GF

Table 1. Descriptive statistics for local authorities in Wales 2005–06 to 2009–10.

	Units	*N*	*Mean*	*SD*	*Min.*	*Max.*	*Median*
Total service expenditure (TSE)	£'000	107	378,942	197,594	164,401	1,375,509	329,940
Audit fee	£'000	107	250	71	128	463	227
Audit fee as % of TSE	%	107	0.075	0.027	0.029	0.150	0.066
Reported surplus/(deficit)	£'000	107	(38,372)	78,320	(541,628)	7,910	(15,876)
Transfer to the general fund	£'000	107	220	1,839	(7,071)	6,052	65
Reported balance on the general fund	£'000	107	8,600	4,491	2,377	25,796	7,942
Audit adjustments:							
Absolute change of the surplus/deficit	£'000	92	11,319	42,737	2	387,538	2,092
Absolute change as % of original value	%	92	46.367	99.838	0.013	691.235	13.169
Absolute change of the transfer	£'000	46	525	880	16	4,956	268
Absolute change as % of original value	%	46	65.374	83.883	2.162	332.143	32.558
Absolute change of the general fund	£'000	48	591	983	1	4,956	203
Absolute change as % of original value	%	48	5.308	7.256	0.010	41.457	2.973

adjustments to the general fund were made through the income statement in the form of a 'transfer to the general fund' (46 out of 48 adjustments), providing further evidence of the significance of this balance. The adjustments to the surplus/deficit, at a median value of £2 million, had a much higher absolute value than that of both the adjustments to the transfer to the general fund (mean £220,000) and the general fund itself (£591,000), indicating that adjustments also affect other reserve balances in addition to the general fund. The outlier adjustment of £387 million to the reported surplus/deficit represented an adjustment concerning a regulatory change in valuation method of council dwellings which was not reflected in the pre-audit financial statements. Post-audit, the assets were impaired by £431 million, representing a significant portion of the net adjustment of £387 million. This impairment charge was statutorily transferred to an alternative reserve, the capital adjustment account resulting in a nil impact on the general fund.

The incidence and size of adjustments processed for each local authority during the period 2005–06 to 2009–10 varied considerably. Table 2 shows that out of 92 observed adjustments to the reported surplus, each authority experienced an audit adjustment in at least three of the five years of the study with the percentage adjustment to the original balance ranging from 6% to 172%. However, in contrast, for four local authorities these did not translate into any adjustments to the general fund. Further, although adjustments to the general fund transfer appear large, with a maximum (mean) value of 228% (65%), they translate into a maximum (mean) adjustment to the general fund of 12.5% (5.3%).

To identify the economic significance of the relationship between audit fees and audit adjustments, we tested whether the audit fees of those local authorities with adjustments were significantly different from those without adjustments. Table 3 shows the mean audit fees as a % of total service expenditure for local authorities who experienced an audit adjustment compared with those who had no adjustment. This table shows that the mean audit fee for those local authorities with an adjustment to their general fund was significantly different (at 1% significance) from those that had no adjustment. The difference amounted to 0.012% of total service expenditure which, for a local authority with mean expenditure of £379 million, is approximately £45,000. The situation was similar for local authorities with an adjustment to the amount transferred from the income statement to the general fund (5% significance). The difference here was 0.01% of service expenditure, which resulted in an estimated £38,000 difference in fees for an average-sized local authority.

In contrast, however, there was no evidence that adjustments to the surplus/deficit are significantly associated with audit fees. However, this could be a consequence of the high incidence of adjustments to the reported surplus which severely reduces the number of comparator observations with no adjustments.

Finally, table 4 shows the direction of audit adjustments. Although there was little difference in the number and size of income-increasing and income-decreasing adjustments to the reported surplus/deficit, the number of downward adjustments to the general fund transfer and to the general fund balance exceeded the number of upward adjustments. Overall, a mean reduction of 29% in the general fund transfer translates into a mean reduction in the general fund of 2%.

Table 2. Analysis of audit adjustments by local authority.

		Adjustments to:					
		Income statement		*Transfer to general fund*		*General fund balance*	
Local authority	*No. of observations*	*No. of adjustments*	*Mean % adjustments*	*No. of adjustments*	*Mean % adjustments*	*No. of adjustments*	*Mean % adjustments*
1	5	3	75.77	1	200.00	0	0
2	5	3	15.04	1	11.31	1	1.22
3	5	3	17.22	2	25.89	2	6.07
4	4	4	46.67	4	139.35	4	9.36
5	4	4	86.82	1	227.95	1	5.99
6	4	4	20.22	2	16.54	2	1.70
7	5	4	60.89	0	0	0	0
8	5	4	28.05	3	28.16	3	3.19
9	5	4	24.26	1	12.35	3	12.47
10	5	4	69.01	1	2.30	1	0.28
11	5	4	46.56	3	29.39	4	12.11
12	5	4	36.57	4	63.75	4	2.38
13	5	4	32.84	0	0	0	0
14	5	4	14.54	0	0	0	0
15	5	4	6.40	2	19.96	2	3.43
16	5	5	20.40	3	75.55	3	2.40
17	5	5	29.58	5	61.94	5	7.68
18	5	5	15.70	2	4.91	2	0.48
19	5	5	113.55	5	90.20	5	3.90
20	5	5	171.91	2	8.21	2	4.31
21	5	5	47.85	1	210.50	1	1.37
22	5	5	11.09	3	73.13	3	2.15
Total	107	92	46.37	46	65.37	48	5.31

Discussion and conclusions

This paper exploits the availability of pre-audit financial statements in UK local government to investigate the scale and incidence of audit adjustments in Welsh local authorities and their impact on audit fees. Using both pre- and post- audit financial statements, we measure audit adjustments as the % change in the balances on three potentially sensitive balances: the reported surplus, the transfer to the general fund and the general fund balance.

Adjustments to the general fund, the balance on which is both politically and legally sensitive, represented a significant proportion (approximately half) of all adjustments to the income statement; audit fees were sensitive to adjustments to the general fund but not to the income statement; and there was considerable variation in the scale and incidence of audit adjustments between local authorities. Finally, we found that audit adjustments suggested a more conservative reporting of the surplus/deficit and of the general fund balance. These findings are consistent with the direction of audit effort towards balances with political and regulatory sensitivity and therefore of enhanced audit risk. The variation in audit adjustments between local authorities suggests that institutional specific factors, such as the quality of the finance function, may be important in determining the quality of the financial statements presented for audit. This represents an area of possible further research.

This study is the first of its kind to be conducted in Wales, where the public audit regime is increasingly divergent from that in England. Wales has so far eschewed the radical reforms which are being implemented in England and which have delivered up to 40% reductions in the audit fees of local authorities and other local public bodies. The austerity-driven reductions in Welsh audit fees have been much lower and so the imperative to generate savings through local management action is more pressing. One such source of savings is through the improvement of pre-audit financial reporting quality by taking action to avoid costly audit adjustments. For a local authority with mean service expenditure of £379 million, the effect of an audit adjustment to the general fund during the period of this study is estimated to be approximately £45,000, 18% of the mean audit fee of £250,000. Given that our study was conducted in the five year period up to 2009–10, fees since that time will have been subject to austerity-driven downward pressures on the one hand and to upward pressures on the other arising from both inflation and from the increased complexity of IFRS reporting. Our findings overall, however, suggest that an improvement in pre-audit financial reporting quality in those local authorities experiencing audit adjustments could release significant reductions in the audit fee.

Further, although these cost savings are low in comparison both with the savings achieved through the reform of public audit in England and with the overall austerity related savings required from local authorities by central government, they have a symbolic significance which goes beyond their scale. All budget holders, but perhaps especially overhead departments, need to demonstrate a commitment to making a contribution to overall savings and to delivering services more efficiently and effectively. Moreover, in the case of audit, there are other potential benefits from a reduction in differences between the pre- and post-audit financial statements, such as increased stakeholder confidence in financial governance. Finally, these findings provide evidence of potential interest to the WAO, the Chartered Institute of Public Finance and Accountancy (CIPFA) and the Welsh Local Government Association, each of which has a role in advising and supporting local authorities on best practice in relation to the quality of their internal financial reporting.

Finally, while the extent of the analysis in this study was constrained by the number of local authorities in Wales, the findings provide sufficiently interesting and novel insights to indicate the potential value of further research. Such research might for example, explore the significance of pre-audit financial reporting quality, in other, larger audit jurisdictions such as that in England and could be extended to include considerations of timeliness and streamlining of the financial statements, topics which have recently been of interest to HM Treasury (2014) and to the profession (PwC, 2010). Of further interest also would be the influence of IFRS adoption on audit fees in local authorities. Our small sample, and the limited period since IFRS adoption in local authorities, precluded such an investigation in the context of this paper. The literature investigating the impact of IFRS adoption in the private sector finds that audit fees increase post-IFRS adoption (De George *et al.*, 2013; Kim *et al.*, 2012), but such an investigation has not yet been conducted in a public sector setting where both the financial reporting and the audit regulatory regimes feature distinctive differences compared with the private sector.

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Table 3. Mean audit fees of local authorities with audit adjustments compared with those with no adjustments.

Indicator	*Income statement surplus/deficit*		*Transfer from the income statement to the general fund*		*General fund*	
	Incidence	Audit fees as % TSE	Incidence	Audit fees as % TSE	Incidence	Audit fees as % TSE
No change ~~0~~	15	0.082	61	0.071	59	0.069
Change ~~1~~	92	0.073	46	0.081	48	0.081
Difference		0.009		0.010*		0.012**

*Significant at the 5% level; **significant at the 1% level; TSE = total service expenditure.

Table 4. Analysis of the direction of adjustments to the statement of accounts.

Direction of adjustment	*Income statement surplus/deficit*		*Transfer from the income statement to the general fund*		*General fund*	
	Incidence	Mean % change	Incidence	Mean % change	Incidence	Mean % change
Increase	47	43.42	16	52.27	17	4.30
Decrease	45	-49.44	30	-72.37	31	-5.86
All	92	-2.00	46	-29.02	48	-2.26

Note: Adjustments reported in previous tables are absolute values but here we are presenting directional values.

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